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CONSUMER FINANCE LAW

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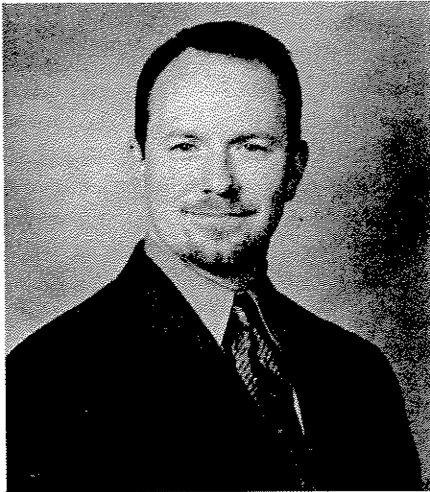

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I. Introduction

Negative equity occurs when a customer owes more on the trade-in vehicle than what it's worth. The rather simple formula for negative equity is:[1]

$$P_{144} = \mathrm{Min}(221{,}818.30, 234{,}189.82)$$

$$10{,}000(1+i)^{144-0} + \sum_{j=0}^{143} 725(1+i)^{144-j} = 221{,}818.30$$

$$i = .007708844$$

Now that everyone understands that, let's see how this simple concept is disclosed to the consumer under the federal Truth in Lending Act (TILA).[2]

II. How Should Negative Equity be Disclosed in a Retail Installment Sales Contract?

A. Regulation Z

Federal Reserve Board (FRB) Regulation Z[3] defines a downpayment as an amount, including the value of any property used as a trade-in, paid to a seller to reduce the cash price of goods or services purchased in a credit sale transaction.[4] A negative number does not reduce the cash price...it increases the cash price. Therefore, you cannot have a negative downpayment. Nonetheless, the FRB Official Staff Commentary to Regulation Z provides two applicable rules for disclosing negative equity.[5]

B. Rule One: No Cash Payment

In a credit sale, the downpayment may only be used to reduce the cash price. This means that when a trade-in vehicle is used as the downpayment and the amount of the existing security interest in that automobile exceeds the value of the automobile, the creditor must disclose $0 on the downpayment line, rather than a negative number. An example of this is when a consumer owes $10,000 on an existing automobile loan, and the vehicle's trade-in value is only $8,000, leaving a $2,000 deficit. The credit contract should disclose a downpayment of $0, not a negative $2,000.

C. Rule Two: Cash Payment

If the consumer makes a cash payment with his or her trade-in, the creditor has the option to disclose the entire cash payment as the downpayment, or may apply the cash payment first to any excess lien amount on the trade-in and then disclose any remaining cash as the downpayment. In the preceding example, if the downpayment disclosed is equal to the cash payment, the $2,000 deficit must be reflected as an additional amount financed under Regulation Z.[6] If the customer's cash payment is less than the negative equity, *e.g.*, $1,500 in cash (which does not extinguish the $2,000 deficit in our example), the creditor may disclose a downpayment of $1,500 or $0. If the consumer pays $3,000 in cash,

1. Although the calculation and disclosure of negative equity on a Retail Installment Sales Contract might seem this complicated, it is not.

2. Consumer Credit Protection Act, Pub. L. No. 9-321, Tit. I., codified at 15 U.S.C. §§ 1601-1667e.

3. 12 CFR pt. 226.

4. 12 CFR § 226.2(a)(18).

5. FRB Official Staff Commentary to Regulation Z, ¶ 226.2(a)(18)3.

6. *See* Regulation Z, 12 CFR § 226.18(b)(2).

the creditor may disclose a downpayment of $3,000 or $1,000 ($3,000 cash downpayment less the $2,000 deficit).

III. Other Considerations

A. Netting

Netting is a term for one of the concepts illustrated above. A creditor may elect to "net" the customer's cash against the negative equity, or show the cash as a downpayment and show the amount of negative equity in the amount financed.

B. Regulation Z Itemization of Amount Financed

The TILA disclosure[7] should include a separate written itemization of the amount financed for each transaction, which includes: the amount of any proceeds distributed directly to the consumer; the amounts credited to the consumer's account with the creditor; any amount paid to other persons by the creditor on the consumer's behalf (the creditor must identify those persons) and prepaid finance charges.[8]

However, that is only a minium standard for the information to be included in the itemization of the amount financed. Creditors have considerable flexibility in revising or supplementing this information. Creditors may add categories to the itemization and include the cash price and the downpayment in a credit sale.[9]

C. Example

If a credit sale involves a trade-in vehicle, and the existing lien on the trade-in vehicle exceeds the vehicle's value, the creditor may disclose: (1) the consumer's trade-in value; (2) the creditor's payoff of the existing lien; and (3) the resulting additional amount financed.[10] For example:

Itemization of Amount Financed

Total Cash/Rebate Down $_____

Trade-in Allowance $_____

Less: Amount Owing $_____

Paid to: ______________________

Net Trade-in (Allowance – Amount Owing) $______

Net Cash/Trade-In (Total Cash/ Rebate + Net Trade-in) $______

Amount to Finance (If Net Cash/Trade-in is Negative) $_______

IV. State Law

The federal disclosure rules for disclosing negative equity in a Retail Installment Sales Contract are relatively straightforward. However, the federal rules for disclosure of negative equity are only part of the regulatory landscape. Federal law only deals with the disclosure of the transaction, not with its substance. That's where state law comes into play. One example of the critical issues surrounding a trade-in and the state law treatment of negative equity is the *10,000 RV Sales, Inc.* case.[11]

In the *10,000 RV Sales* case, a motor home buyer, Ms. Thompson, signed a conditional sale contract to purchase a used motor home from 10,000 RV. Thompson required financing to purchase the motor home. As part of the sales transaction, she agreed to trade in her old motor home which was subject to an outstanding balance of $46,000. Although 10,000 RV appraised her trade-in at $30,000, it credited Thompson $54,000 on the trade-in, creating an "over-allowance" of $24,000. The over-allowance permitted Thompson to show on the face of the contract a positive net trade-in value of $8,000 ($54,000 – $46.000 balance owed) to apply toward the downpayment of the used motor home. However, because Thompson owed $46,000 on her old motor home and 10,000 RV appraised it at $30,000, a negative equity of $16,000 actually existed. 10,000 RV explained that the purpose of including an over-allowance in the cash selling price was to eliminate the appearance of negative equity and to enable Thompson to obtain lender approval for the purchase.

The over-allowance would not have been created for a cash buyer because a cash buyer would not need to obtain financing in a cash transaction. 10,000 RV did not disclose to Thompson that it had created the $24,000 over-allowance on her trade-in vehicle. Without Thompson's knowledge or consent, the $24,000 over-allowance was added to the $69,398 price of the used motor home that a cash purchaser would pay, to show a cash price of $93,398 on her financing contract.

Thompson sued 10,000 RV, claiming that the value of her trade-in vehicle was inflated to hide the negative equity associated with the transaction, the negative equity was included in the cash price of the used motor home, there was no disclosure that the negative equity was included in the cash price, and that 10,000 RV's standard practice was not to disclose the inclusion of negative equity in the cash price on the financing contact.

The trial court ruled in favor of Thompson and found that 10,000 RV violated certain consumer protection statutes, including the California Automobile Sales Finance Act (ASFA), the Consumers Legal Remedies Act, and California's Unfair Competition Law. 10,000 RV appealed the ruling, challenging the trial court's injunction that prohibited it from including a trade-in over-allowance in the vehicle cash price on a financing contract. The California Court of Appeal relied on expert testimony, indicating that the practice of including a trade-in over-allowance in the vehicle cash price violates the California ASFA and its corresponding federal regulation, Regulation Z, because the buyer is unaware that she is financing part of the existing

7. *Id.* § 226.18.

8. *Id.*

9. FRB Official Staff Commentary to Regulation Z. § 226.18(c)2.iii.

10. *Id.*

11. Thompson v. 10,000 RV Sales, Inc., 130 Cal. App. 4th 950 (2005).

obligation on the trade-in vehicle (*i.e.*, the negative equity) in addition to a portion of the purchase price of the new vehicle.

Because the cash price of the motor home affected the calculation of sales tax and license and registration fees, which are computed on the cash price, accurate disclosure was imperative. The appellate court stated that to the extent the cash price for a financed purchase is inflated above the selling price in a comparable cash transaction, the difference is a finance charge, which must be properly disclosed. In Thompson's case, the cash price of the used motor home should have been $69,398 in both a cash and credit transaction. However, the cash price for the used motor home in Thompson's credit transaction was $93,398.

The $24,000 difference that constituted a finance charge was not properly disclosed to Thompson as a finance charge, nor was the $16,000 properly disclosed as negative equity. Therefore, the appellate court found that by inflating the cash price of the used motor home to include the trade-in over-allowance and hiding the appearance of negative equity, without full and complete disclosure to its customer, 10,000 RV violated the California ASFA and other California consumer protection laws.

V. Conclusion

Although the TILA requirements for disclosing negative equity in a Retail Installment Sales Contract are relatively uncomplicated, they only address the disclosure of negative equity in a credit sale transaction; they don't deal with the substance of the transaction. In addition to carefully reviewing the federal disclosure rules for disclosing negative equity in a Retail Installment Sales Contract, a creditor should also carefully review substantive state law dealing with negative equity to ensure that it is correctly complying with the state law requirements.

State Foreclosure Prevention...

(Continued from page 207)

are borrowers with "exotic" mortgages, which the Program defines as adjustable rate, balloon payment, or negative amortization mortgage loans. The Department has approved approximately forty lenders, including institutions such as JP Morgan Chase Bank, N.A. and Chevy Chase Bank, F.S.B.

Under the Program, the lenders underwrite new loans according to their own guidelines, and the regulators whom your authors have consulted at the Department advised that the Program will generally only be available to eligible borrowers who are current on their loan payments. Eligibility under the Program is limited to borrowers with incomes and home values below maximum limits specified by county. In addition, the property securing the loans must be the primary residence of the borrower and the combined loan-to-value ratio must be eighty-five percent or greater. Mortgage insurance is required on all loans originated under the Program. A variety of fixed-rate mortgage products is available under the Program, including loans with a forty-year term and interest-only options. Notably, there is no cash-out option available. The closing costs for the refinancing can be included in the principal amount of the new loan.

The Program is funded through an issue of bonds. Approved lenders pool together the loans they have made under the Program and sell the pools to the Department. The Department purchases the loans with funds from the bond issuance.

B. Massachusetts

On April 30, 2007, Massachusetts Governor Deval Patrick directed the Massachusetts Division of Banks (the Division) to seek delays of foreclosures by mortgage lenders, on a case-by-case basis, for any borrower who has filed a complaint with the Division. It is currently unclear how long such a suspension may last, although press reports have suggested that the Division may seek foreclosure delays of up to two months. Further, though the suspension program is nominally available to any person who files a complaint with the Division, the Division appears to wield significant discretion in determining whether it will pursue a delay. While the Division's enforcement criteria remain unclear, it is anticipated that the Massachusetts anti-predatory lending statute and the state requirement that certain refinance transactions be in the "borrower's interest" may play significant roles. However, the foreclosure suspension program has the potential to affect nearly any foreclosure of a residential mortgage loan securing the principal residence of a borrower in the state of Massachusetts. In addition, the directive in Massachusetts for lenders to use the mandated foreclosure delay to work in good faith with borrowers seeking to make their loan payments is odd if it suggests that lenders are not already doing so, and potentially takes the Division of Banks into new areas of law.

Moreover, Governor Patrick has instructed the Division to review consumer complaints and refer homeowners to reputable homeownership counselling firms. Governor Patrick has also asked mortgage lenders to utilize the foreclosure delay period to work in good faith with homeowners who are struggling to make their mortgage payments. Specifically, Governor Patrick has asked mortgage lenders to consider modifying the terms of their loans from adjustable rate mortgages into fixed rate loans. The Division has also extended the hours of its mortgage hotline, which now operates from 7:30 a.m. to 6:00 p.m.

C. Ohio

On April 2, 2007, the Ohio Housing Finance Agency (OHFA) announced a refinance program, entitled the Opportunity Loan Refinance Program (the Program), which is designed to help borrowers who expect to face difficulty making their mortgage payments when their payment amounts increase on their adjustable rate or interest-only loans, as well as those who have experienced changes in life circumstances (*i.e.*, divorce, unemployment). The Program is limited to borrowers who are current with their loan payments and, as such, is not a foreclosure rescue program, but rather (as noted above) is a foreclosure prevention program.

The Program offers thirty-year, fixed-rate loans to such borrowers. The Program also offers a twenty-year, fixed-rate second mortgage option of an amount up to four percent of the appraised value of the home. The second mortgage may be used to pay charges required to payoff of the first mortgage, such as late fees or attorney fees. Interest rates on the optional second mortgage will be two percent above the rate on the first mortgage obtained under the Program. Borrowers may be reimbursed for out-of-pocket costs that were paid for appraisals, credit reports or up-front hazard insurance payments, with appropriate documentation. Mortgage insurance is required for loans that are above an eighty percent loan-to-value ratio. The loans will be provided through approved lenders. There are about 200 lenders approved to originate loans under the Program, including lenders such as Countrywide Home Loans and Wells Fargo Home Mortgage. The Program is backed by the sale of taxable bonds. OHFA hopes that up to $500 million each year can be provided under the Program, if the demand exists.

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